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THE SECRETARY OF COMMERCE
Washington, D.C. 20230

MEMORANDUM FOR THE CABINET COUNCIL ON COMMERCE AND TRADE

SUBJECT: The CCCT Working Group on Intellectual Property Recommendation that the Administration Support (1) S.32, "Record Rental Amendment of 1983," and (2) S.33, "Consumer Video Sales/Rental Amendment of 1983."

BACKGROUND

(1) S.32, "Record Rental Amendment of 1983"

This bill would amend the Copyright Act of 1976 (Title 17 of the United States Code) to prohibit commercial record rentals without the consent of the owner of the copyright in the recording.

Under the existing "first-sale doctrine" of the copyright law, a purchaser of a phonorecord is not liable to any copyright holders for the subsequent rental, sale, or other disposal of that copy. Thus, one who purchased a copyrighted sound recording may rent it to others in competition with the record company's effort to sell it and the copyright owners derive no benefit from such commercial use of the work.

Thus, the first sale doctrine, coupled with advances in recording technology, effectively weakens the protection for intellectual property afforded by copyright and serves as a disincentive to creators. This result is contrary to the rationale underlying copyright protection: to benefit the public by stimulating new works through the incentive of the grant of exclusive rights to authors. These exclusive rights are intended to permit authors, composers, and artists to reap the rewards of their creations when consumers choose them over available alternatives.

Members of the American music industry are concerned that rapidly proliferating commercial record rentals pose a threat to the industry. Rented records, they believe, are almost invariably taped at home, thereby displacing record sales.

The record rental business began in Japan in June 1980 and has now grown to more than 1,700 outlets. Record sales by retail stores in the vicinity of rental outlets in Japan have dropped 30 percent and the Japanese record industry has suffered its first sales decline in 25 years. A recent survey suggests that 97.4 percent of all Japanese rental outlet users tape rented records at home.

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The U.S. rental record industry is not yet two years old (starting in September 1981) and consists of only 250 outlets. However, the U.S. music industry projects that the U.S. rental record business will have the same growth and effect on retail record sales as has been experienced in Japan. Music industry spokesmen argue that record rentals will reduce the sales volume of retail stores and will also place such stores at a competitive disadvantage with rental outlets.

Further, the owner of the copyright in the sound recording and the owner of the copyright in the musical work receive no compensation from record rentals or unauthorized home taping. Record sales fuel the entire music industry. A decline in sales revenue affects the livelihoods of songwriters, publishers, recording artists, vocalists, musicians, manufacturers, suppliers, distributors and retailers. The music industry says that consumers will also be hurt by a decrease in record sales--if sales decrease, unit prices will rise, and nonprofitable, subsidized music such as classical, jazz, ethnic, and gospel music will disappear.

The record rental business has grown for several reasons. First, the technology for home taping has become quite good and moderately priced. The development and imminent marketing of the digital "compact disc" may increase record rentals even more. This disc--a technological breakthrough--is a small, virtually indestructible record album which can be rented innumerable times without degradation of quality and which will produce better sound particularly suited to high-quality reproduction. Second, the first-sale doctrine has allowed the purchaser who rents out the record to recover the purchase price many times over by rental fees which can be set very low.

Congressional Action

A proposal similar to S.32 was introduced in the 97th Congress, [H.R.5488, Edwards] and hearings were held on April 21, 1982, before the Senate Judiciary Committee. No further Congressional action occurred on this proposal in the 97th Congress. In the 98th Congress, S.32 [Mathias] was the subject of a hearing before the Subcommittee on Patents, Copyrights, and Trademarks of the Senate Judiciary Committee on April 29, 1983. S.32, amended, was reported favorably by the Senate Judiciary Committee (S.Rept. 98-162) and passed the Senate on June 28. It awaits consideration in the House. A similar bill, H.R.1027 [Edwards], was introduced in the House this year but there has been no action.

In reporting S.32, the Senate Judiciary Committee found that litigation would not be an effective solution to the pattern of rental and taping, nor would private contractual remedies rectify the problem. The Committee concluded that "a limited modification of the first-sale doctrine is warranted to remove the threat that commercial record rentals pose to the health of

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America's music community" (S.Rept. 98-162). Supporters of the bill include the Copyright Office, the record industry, music publishers, songwriters, performer's unions, record retailers, as well as others involved in the music industry. The only opposition to S.32 comes from record rental dealers--who declined to testify at the hearings--and indirectly from opponents of S.33 who fear the precedent-setting nature of a modification of the first-sale doctrine for phonorecords.

S.32 would explicitly allow the owners of copyright in sound recordings and underlying musical works to share in the revenues produced in the rental market. It would not forbid taping of records nor would it change the first-sale doctrine with respect to resale, personal use or display, or nonprofit use or lending of copies.

Two important features of S.32 are (1) that it is wholly consistent with the principles that underlie the antitrust laws and would not create an antitrust exemption, and (2) compulsory licensing provisions which now apply to the sale of sound recordings of musical works will also apply to the rental of such recordings.

This latter provision was added by the Senate Judiciary Committee as a new Section 3 to S.32 to make it clear that the bill is fully applicable to both the owner of copyright in the sound recording (typically the record company) and to the owner of copyright in the underlying musical work (typically the songwriter/music publisher). Under this provision, if a record company authorizes commercial record rentals, it will pay a royalty to the songwriter/music publisher on any rental revenues in the same proportion as it shares sale revenues under existing Section 115 of Title 17. The Copyright Office would issue implementing regulations as it has done for the existing Section 115.

(2) S.33, "Consumer Video Sales/Rental Amendment of 1983"

This bill would modify the first-sale doctrine as it applies to video recordings to permit the copyright owner to participate directly in the video rental business by receiving royalty income from the rental transaction. Currently, a burgeoning video tape rental business exists from which the copyright holder derives no economic benefit. This situation has arisen from technological advances of the past decade which have provided consumers with a number of new home video programming possibilities.

Home video system sales have grown to nearly $9 billion in 1982, of which video cassette recorders (VCRs) comprised almost $1.9 billion. In 1981, VCR sales, at $1.13 billion, were a 69 percent increase over 1980 sales and in 1982, VCR sales increased almost 170 percent over 1981.

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The first successful VCRs were introduced in 1975. Since then, competition and technical developments have helped improve VCR technology, and VCRs have an excellent potential for continued growth. As of June 1982, the cumulative number of VCRs sold was 3.86 million units, an estimated 4.7 percent penetration of the market. Industry estimates are that by 1990 there will be 45-50 million VCR units in U.S. homes.

Surveys show that the majority of VCR purchasers buy them for home taping of television programs for later viewing, referred to as "recording off the air." However, the availability of prerecorded tapes of movies has increased use of VCRs for movie viewing. In 1981 the estimated retail sales of prerecorded tapes was $270 million. Because of relatively high purchase prices for those tapes ($30-$100), and the relatively small number of times one might wish to view a single movie, rentals of prerecorded tapes began several years ago at retail outlets. Retailers are able to rent tapes without permission of the copyright owners due to the "first-sale doctrine," and the copyright holder has no share in the profits from this growing use of copyrighted material.

Several years of experience with tape rentals have shown that consumers choose rental over the more expensive tape purchases. Retailers say that rentals outnumber purchases by 6 to 1, but estimates go as high as 45 to 1. The average price of a prerecorded tape used to be about $50, but that has risen to about $75 with the advent of rentals. Rentals, on the other hand, range from $1 to $10 for a 24-hour period. Movie studios, which are the prime copyright holders for video recordings, have sought to control, or at least derive some profit from, tape rentals. Since they had no legal power to prohibit rentals, the major studios tried a number of different plans to overcome the first-sale doctrine. Among those were surcharges tacked on the sale price, rental-only plans whereby the studio would only rent the cassettes, and maintenance of separate inventories of rental and sales tapes with differing purchase prices for each group. Each of these measures served to increase the sale price of tapes and shifted the market further into rentals.

A February 1982 survey of 10,000 VCR owners showed that VCR cassette renters comprise almost 40 percent of the sample, up from 16 percent of the sample in the comparable 1981 survey. Cassette purchasers, conversely, went down from almost 20 percent in the 1981 survey to 10.5 percent. The survey also demonstrated that demand for tapes is elastic and that consumers will be willing to purchase more tapes if the price drops significantly (to under $40).

Congressional Action

In the 97th Congress, Section 5 of H.R.5488 [Edwards] and Section 5 of Amendment No. 1333 [Mathias] to S.1758 [DeConcini] addressed the video recording first-sale doctrine issue. Though hearings

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were held in the House in 1982, the bills were complex and dealt with a number of controversial issues, and there was no action on them.

The 98th Congress addressed the video recording and first-sale doctrine issue directly in identical bills S.33 [Mathias] and H.R.1029 [Edwards]. These bills would modify the first-sale doctrine to permit the copyright owner to participate directly in the video rental business by receiving royalty income from the rental transaction. Proponents argue that the strengthened protection for intellectual property resulting from this legislation will restore the incentives the new technologies have taken from the creators of audiovisual works and would, in the long run, benefit the public. Opponents believe strongly that altering the first-sale doctrine will enable the movie industry to extend its control over the rental industry and increase prices significantly. They charge that the potential for antitrust violations is significant.

At hearings on S.33 before the Senate Judiciary Subcommittee on Patents, Copyrights, and Trademarks on April 29, 1983, witnesses in favor of the bill testified that its passage would encourage growth of both rental and sale of VCR cassettes. One witness cited his company's experiment with lowering the price of a popular movie by $30. All available copies of the movie were sold while the rental market remained unaffected. Proponents argued that due to artificially high sales prices now, consumers only have the rental option. Access to a copyright infringement remedy, they argue, could drop wholesale prices by 30-40 percent, opening up a real sales market. Also video retailers would face much lower costs in maintaining inventories. Proponents note that S.33 confers no immunity from antitrust laws and that it merely gives film copyright owners the same legal rights which manufacturers of other goods now have.

Opponents of the bill testified that a change in the first-sale doctrine would raise rental prices, subject retailers to anticompetitive control, and impede the distribution of new technology.

The Subcommittee has not yet acted on S.33. In the House, no action has been taken on this issue in the 98th Congress. S.33 does not contain compulsory license provisions, nor would they be necessary due to the different nature of the copyright held in an audiovisual work from a sound recording. The exercise of rights under S.33 would be subject to existing antitrust laws.

OPPORTUNITY PRESENTED

The major impact of a Cabinet Council endorsement of S.32 and S.33 would be to encourage Congressional action on these audio and video recording issues and to strengthen the intellectual property rights aforded by the copyright system. The first-sale doctrine issue is related to the extremely controversial home

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taping issues in the Betamax case, and has been considered with them in the Congress.

In the Betamax case, Universal City Studios and Walt Disney Productions sued Sony Corporation to enjoin the manufacture and sale of Sony's Betamax VCR. The District Court's ruling that in-home video taping was a "fair use" of copyrighted material (480 F. Supp. 429) was reversed by the Ninth Circuit Court of Appeals (659 F.2d 963). The Supreme Court granted certiorari to review the issues on June 14, 1982. Although both the Congress and the Administration appear to have been awaiting guidance from the Court on these issues, the Court announced on July 6 that it would delay any decision until at least the October 1983 term.

One proposed "remedy" for home taping in the Betamax case--a "tax" on VCRs and blank cassettes to be shared among copyright owners--is not the preferred remedy for the rental of phonorecords or audiovisual works. The Working Group believes strongly that the remedy embodied in S.32 and S.33--a copyright owner sharing in the rental receipts in the same proportion as in sale receipts--is the one the Administration should support.

TECHNICAL ISSUE TO BE RESOLVED

One issue not agreed upon by the Working Group is whether the provision of S.32 and S.33 should apply to existing copyrighted works or only to "new titles," i.e., works copyrighted after the effective date of the acts.

S.32, as passed by the Senate, and S.33 would not apply to any work owned by someone prior to the effective date of the act. Thus anyone who acquired ownership of a copyrighted audio or video work prior to enactment of S.32 or S.33 could continue to rent that work without the copyright owner sharing in the rental income.

One member of the Working Group on Intellectual Property took the position that S.32 and S.33 should only apply to works copyrighted after the date of enactment. The rationale for that position is that these bills are intended to stimulate creativity and therefore the added protection of the bills is not necessary for existing works.

The counterargument is that the intent of the legislation is that copyright owners be permitted to develop two separate markets for commercializing copyrighted works as expressed in phonorecords and video cassettes. Particularly with respect to video cassettes, one market is the commercial rental market where a single cassette is provided to a retailer to rent many times over for his and the copyright owner's gain. The other market is the sales market where a copyrighted work is sold at wholesale to the retailer, who in turn sells it with an appropriate retail markup. The strong view of the creative industry is that the present law

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distorts the opportunity to provide copyrighted works in these two quite different markets in an economically efficient way. The view is that if the legislation is limited to only "new titles," this distortion will continue for the foreseeable future. For example, the Motion Picture Association of America (MPAA) states that 1,463 copyrighted motion pictures are now available on prerecorded video cassettes, not including X-rated motion pictures. During 1982, which was viewed as an exceptionally productive year, the combined output of all nine MPAA companies was 180 films. If S.33 is limited to only new titles, there could be no efficient market mechanism developed for such a small number of titles.

This issue needs to be resolved by the Cabinet Council on Commerce and Trade.

RECOMMENDATION

The CCCT Working Group on Intellectual Property recommends Administration support of both S.32 and S.33. The first-sale doctrine, as applied to copyrighted phonorecords and audiovisual works, undermines the incentive to create fostered by the copyright system. Enactment of S.32 and S.33 would, the Working Group believes, enhance the incentive to create. It would require no amendment to existing antitrust laws and would leave the first-sale doctrine intact for copies of works other than phonorecords and audiovisual works and with respect to resale, personal use of display, or nonprofit use or lending of the copies.

The strengthened protection for intellectual property embodied in S.32 and S.33 will restore the incentives which new audio and video technologies have taken from the creators of those works. Such practices clearly will be beneficial to the public.

Secretary of Commerce

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